

# The oversight of payment and securities settlement systems in Hong Kong

by the Banking Development Department

The Clearing and Settlement Systems Ordinance, which establishes a statutory regime for the Monetary Authority to designate and oversee important clearing and settlement systems<sup>1</sup>, became effective in November 2004. By the end of 2005, the HKMA had completed its first-year oversight cycle of five clearing and settlement systems designated under the Ordinance. This article describes the oversight activities conducted by the HKMA under the Ordinance and the informal oversight framework for retail payment systems in Hong Kong.

## Introduction

A formal statutory regime for the oversight of payment and securities settlement systems was formulated in Hong Kong in 2004 against the background of an assessment made by the International Monetary Fund (IMF) in 2002. In the second half of 2002, the IMF undertook a Financial Sector Assessment Programme (FSAP)<sup>2</sup> examination of Hong Kong and published a summary report in June 2003. The IMF report concluded, among other things, that the market infrastructure in Hong Kong had all the necessary characteristics to support the efficient functioning of financial markets. However, it recommended that consideration should be given to the introduction of statutory backing for the responsibilities assumed by the HKMA in overseeing the payment and securities settlement systems in Hong Kong. It also recommended that appropriate legislation should be introduced to provide statutory backing for the finality of settlements, that is, to ensure that the transactions, if settled, are final, irrevocable and unconditional and that the settlement finality is protected from insolvency laws or any other laws.

## The Clearing and Settlement Systems Ordinance

On 10 December 2003, a Clearing and Settlement Systems Bill was introduced into the Legislative Council to provide a statutory oversight regime and settlement finality for important clearing and settlement systems in Hong Kong. The Clearing and Settlement Systems Ordinance (CSSO) was enacted on 2 July 2004 and came into force on 4 November 2004.

The CSSO empowers the Monetary Authority to designate and oversee clearing and settlement systems that are material to the monetary or financial stability of Hong Kong or to the functioning of Hong Kong as an international financial centre. The objective is to promote the general safety and efficiency of designated clearing and settlement systems.

As the overseer, the Monetary Authority monitors the compliance of designated systems with the safety and efficiency requirements stipulated in the CSSO

<sup>1</sup> Clearing and settlement systems refer to the systems established for the clearing and subsequent settlement of transfer of funds or securities between financial institutions.

<sup>2</sup> The FSAP was conducted by an IMF mission, comprising experts from the IMF, the World Bank and collaborating institutions (such as the UK Financial Services Authority and Banque de France). The mission made two visits in the third

quarter of 2002 to examine Hong Kong's compliance with eight key international standards (e.g. CPSS Core Principles for Systemically Important Payment Systems, CPSS-IOSCO Recommendations for Securities Settlement Systems) covering the banking, securities, insurance and other financial sectors. The IMF confirmed that the financial system of Hong Kong was fundamentally sound and that the market infrastructure was robust and efficient.

and, where appropriate, instigates changes to designated systems to bring them into compliance with the requirements.

The CSSO also provides statutory backing to the finality of settlement for transactions effected through the designated systems. The Monetary Authority issues certificates of finality to designated systems if ultimate settlement of transfer orders is effected within the systems and the systems are in compliance with the safety and efficiency requirements of the Ordinance.

To increase the transparency of the designation and oversight functions of the Monetary Authority, an *Explanatory Note on Designation and Issuance of Certificate of Finality* was issued on 4 November 2004. The Note sets out the policies and procedures the Monetary Authority intends to follow in the designation of clearing and settlement systems and the issuance of certificates of finality under the CSSO. In addition, a statutory *Guideline on the Oversight Framework for Designated Systems under the Clearing and Settlement Systems Ordinance* was gazetted on 26 November 2004 after consultation with the industry. The Guideline explains the Monetary Authority's interpretation of the oversight requirements and the oversight process he intends to follow. The two documents have been posted on the HKMA's website.

## Designation of clearing and settlement systems

By the end of 2004, five clearing and settlement systems had been designated and issued a certificate of finality under the CSSO. They are:

- (a) the Central Moneymarkets Unit (CMU), which provides clearing, settlement and depository services for both Hong Kong dollar and other international debt securities;

- (b) the Hong Kong dollar Clearing House Automated Transfer System (HKD CHATS), which provides clearing and settlement services for all the Hong Kong dollar interbank payments in Hong Kong on a real-time gross settlement basis;
- (c) the Continuous Linked Settlement (CLS) System<sup>3</sup>;
- (d) the US dollar CHATS, which provides clearing and settlement services for all the US dollar interbank payments in Hong Kong on a real-time gross settlement basis; and
- (e) the Euro CHATS, which provides clearing and settlement services for all the euro interbank payments in Hong Kong on a real-time gross settlement basis.

The system operator<sup>4</sup> (SO) and settlement institution<sup>5</sup> (SI) of each designated system are set out in the following table:

	Designated System				
	CLS System	CMU	HKD CHATS	USD CHATS	EUR CHATS
System operator	CLS Bank	HKMA	HKICL*	HKICL*	HKICL*
Settlement institution	CLS Bank	Nil	HKMA	HSBC	Standard Chartered Bank (Hong Kong) Ltd

\*The HKMA and the Hong Kong Association of Banks each owns 50% of the Hong Kong Interbank Clearing Limited (HKICL)

The CLS System is operated by CLS Bank, which is regulated by its home supervisor, the Federal Reserve Bank of New York. Oversight of the CLS System by the HKMA is primarily done through an international co-operative oversight arrangement; hence, it is exempted under section 11 of the CSSO from the HKMA's direct oversight (see later section

<sup>3</sup> The CLS System is a global clearing and settlement system providing payment versus payment (PvP) service for cross-border foreign exchange transactions to remove foreign exchange settlement risk.

<sup>4</sup> The system operator is responsible for the operation of the clearing and settlement functions of the system.

<sup>5</sup> The settlement institution refers to the institution across whose books transfers between participants take place to achieve settlement within the system.

on co-operative oversight). In other words, the HKMA exercises oversight of the four local designated systems - CMU, HKD CHATS, USD CHATS and EUR CHATS.

## Oversight of designated systems

Oversight follows a risk-based approach to continuously monitor and assess the compliance of designated systems focusing on areas of high risk using a wide variety of techniques aimed at detecting problems at an early stage.

The HKMA conducts annual assessments of the compliance of every designated system with the safety and efficiency requirements set out under section 7 of the CSSO. The oversight is conducted through one or more of the following methods:

- (a) off-site review and continuous monitoring;
- (b) on-site examination;
- (c) auditor's report;
- (d) meeting with the management of the SOs and SIs of designated systems; and
- (e) co-operative oversight of cross-border designated systems.

### Off-site reviews and continuous monitoring

These form the core of the HKMA's oversight approach. The reviews enable the HKMA to evaluate the degree of compliance of designated systems with the requirements of the Ordinance and to conduct cross-institutional or peer group analysis.

Monthly information is collected on transaction volumes and values, system performance statistics, incidents of default and non-compliance with operating rules, and significant events in the coming months, which may have risk implications for each designated system. In addition, the HKMA also requires the SO and SI of each designated system to provide supplementary information for off-site

reviews. The information includes submissions of periodic internal or external auditor's reports on various risk areas, business continuity plans, and data on the financial strength and financial commitment of the SO and SI, which should also report any delays or abnormal events of the designated system as soon as possible. This should be followed by a written report to the HKMA within a reasonable time specified by the HKMA, explaining the cause and impact of the event, and the remedial action taken.

### On-site examinations

On-site examinations complement the HKMA's off-site reviews and provide it with the opportunity to assess at first hand how designated systems are being operated, managed and controlled.

On-site examinations are conducted when necessary and their frequencies vary from system to system. In general, the scope of an on-site examination will focus on priority areas identified through the off-site review. These include high-risk areas or where control process validations are needed. An on-site examination report, identifying any area of weakness or concern and making recommendations for remedial action, will be issued to the system operators and settlement institutions.

### Auditor's report

To supplement off-site reviews and on-site examinations, the HKMA may request the SO or SI of a designated system to submit an auditor's report on high-risk areas or other areas of concern to help the HKMA decide whether the system is in compliance with the CSSO.

### Meeting with the management of SOs and SIs of designated systems

The HKMA holds annual meetings with senior management of the SO and SI of each designated system to discuss the findings of the off-site reviews (and on-site examinations if conducted), particularly any significant deficiencies in safety and efficiency identified, or any other matters of concern or mutual interest. The meetings also enable the HKMA to better understand how the SO and SI view and

control risks and how they assess their business situation and future development.

### **Co-operative oversight of cross-border designated systems**

Where appropriate, the HKMA relies on co-operative oversight and works closely with the supervisory authorities of designated systems operated outside Hong Kong. The oversight follows the established international co-operative oversight framework such as that set out in the *Lamfalussy Report*<sup>6</sup> (the Principles for Co-operative Central Bank Oversight of Cross-border and Multicurrency Netting and Settlement Schemes).<sup>7</sup>

### **Follow-up action**

Following evaluation of compliance of a designated system with the CSSO, the HKMA may make recommendations to the system operator and settlement institution asking them to take steps to meet the oversight requirements. It will then closely monitor implementation of the recommendations.

### **First-year oversight cycle**

By the end of 2005, the HKMA had completed its first year of oversight on all the local designated systems. In addition to the regular off-site reviews and continuous monitoring, on-site examinations were conducted including access control, back-up arrangements and business continuity plans.

Meetings with the SO and SI of respective designated systems were held to discuss their past performance and future plans. All designated systems were found to be in compliance with the safety and efficiency requirements of the CSSO.

### **Informal oversight of retail payment systems**

Retail payment systems handle large volumes of transactions of relatively low value. Compared with those of real-time gross settlement systems, the retail payment systems generally carry little, if any, systemic risk. In 2001, the HKMA completed a comprehensive review of retail payment services in Hong Kong to further promote the transparency of their operations. The review examined a number of issues including efficiency, pricing and costs, degree of market access, level of competition and risks associated with the various means of retail payment to ensure the overall stability, efficiency and competitiveness of the systems. It also considered the appropriate regulatory approach for oversight of retail payment services. The review recommended, among other things, introduction of a self-regulatory approach, under which the industry would draw up codes of practice and also monitor their compliance, while the HKMA would oversee the overall implementation of this approach.

In August 2005, the HKMA endorsed a *Code of Practice for Multi-purpose Stored Value Card Operation*, which is a non-statutory code issued voluntarily by the system operator of the Octopus card. The Code was issued to advance the card's general safety and efficiency and to foster public confidence in the system. A self-assessment programme for compliance with the Code is also being developed.

<sup>6</sup> *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* published by the Bank for International Settlements in November 1990. Part D of the Report sets out the principles for co-operative central bank oversight.

<sup>7</sup> The major principles of the framework set out in the *Lamfalussy Report* are:  
(a) the central bank of the country in which a cross-border or multi-currency clearing and settlement arrangement is

located has primary responsibility for the oversight of such an arrangement;

(b) the authority with primary oversight will consult with other relevant authorities, giving particular attention to the system's risk management procedures; and  
(c) the determination of a system's settlement and failure-to-settle procedures should be the joint responsibility of the central bank of issue of a currency included in a system and the authority with the primary oversight responsibility for the system.

## Looking ahead

The HKMA will continue to oversee and promote the safety and efficiency of designated clearing and settlement systems through compliance monitoring. In addition to the large-value interbank payment items, the HKMA, in discussion with the system operators and settlement institutions of HKD CHATS and USD CHATS<sup>8</sup>, plans to extend its oversight to include small-value interbank payment items, such as paper cheques, so that all interbank payments will be brought under the statutory oversight regime.

As part of the informal oversight framework for retail payment systems in Hong Kong, the HKMA plans to work with the credit card industry to develop a code of practice for credit card scheme operators. A similar code is also being planned for debit card schemes.

The oversight regime of clearing and settlement systems is relatively new to Hong Kong. The HKMA will closely monitor developments in the payment industry and, if necessary, refine its oversight framework to keep abreast of international standards and practices.

<sup>8</sup> The plan is not applicable to EUR CHATS as EUR CHATS does not support small-value Interbank payment items.